

Business, Energy and Industrial Strategy and Work and Pensions Committees

Oral evidence: Carillion, HC 769

Wednesday 7 March 2018

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Members present: [Rachel Reeves](#) (Chair); [Heidi Allen](#); [Alex Burghart](#); [Frank Field](#); [Stephen Kerr](#); [Peter Kyle](#); [Nigel Mills](#); [Antoinette Sandbach](#); [Chris Stephens](#).

Questions 998-1209

Witnesses

I: Murdo Murchison, Chairman, Kiltarn Partners, Euan Stirling, Global Head of Stewardship and ESG Investing, Aberdeen Standard Investments, and Amra Balic, Managing Director, Blackrock.

II: Andrew Wollaston, Partner, Global Restructuring Leader and Global TAS Private Equity, Ernst & Young UK, Alan Bloom, Partner, Senior Restructuring, former UK Restructuring Leader and Global Restructuring Leader, Ernst & Young UK, and Lee Watson, Partner, Restructuring, Ernst & Young UK.

Examination of witnesses

Witnesses: Murdo Murchison, Euan Stirling and Amra Balic

Q998 **Chair:** Thank you very much for coming to give evidence to our Select Committee today as we continue our inquiry into what happened at Carillion. We are very keen to hear from the three of you. Your companies were all big investors in Carillion at various points. We are keen to learn from you what you saw in the company, why at various points you chose to sell shares and also what engagement you had with the management team at Carillion over the last couple of years.

I will start my questions with you, Mr Stirling. Standard Life began divesting from the company in late 2015, before others did. What had you seen that others were yet to?

Euan Stirling: We saw a rising risk profile that we felt was not reflected in the share price. The rising risk profile, in our eyes, was reflected in the debt levels that were growing every year and every half-year as the company failed to convert its profitability into cash flow. It continued to make acquisitions that were adding to the debt pile every year. That risk profile not being reflected in the share price was the principal reason that we disinvested from the shares.

Q999 **Chair:** Are you surprised that others did not start doing that earlier?

Euan Stirling: It is a matter of judgment. Different investment styles will see different attractions at different times. It is not really for me to answer on behalf of other investors. I can only explain our own stance. We had been significant investors in Carillion, owning more than 12% of the shares at one point, and it did take quite a while for us to sell down the whole stake, which is why we started in late 2015 and finished that process during 2017.

Q1000 **Chair:** When in 2017 did you cease to be a shareholder?

Euan Stirling: We got down to virtually zero active holding in the first quarter of 2017.

Q1001 **Chair:** By the time the profits warning came, you were no longer a shareholder?

Euan Stirling: That is correct, yes.

Q1002 **Chair:** How engaged were you before you began to divest, and indeed during that period where you were selling shares, with the board at Carillion?

Euan Stirling: It is an integral part of our investment process, meeting the company management and trying to gain as close an understanding of we can of the prospects of the company. In the course of 2014 to 2017 we met with management 13 times. It was mainly meetings with Richard Howson, Richard Adam and the chairman, Philip Green.



Q1003 **Chair:** What assurances did they give you? How did they try to persuade you that your decisions were the right ones and that being a shareholder was a good thing? I assume they did. What did they say to you?

Euan Stirling: Typically, we do find that with management teams. They are well-drilled in how to present the investment case to investors. Our job in that context is to try to scratch the surface to find out more about what is going on underlying with a company. What became clear to us was that the company was going to continue on its strategy despite our questioning of that. That strategy, as I mentioned, was leading to higher debt levels, a higher risk profile and greater complexity within the group, which also was a warning signal to us. It was clear, even through our engagement with the non-executive chairman, that that was not going to alter in any way.

Q1004 **Chair:** If I may ask you, Mr Murchison, and you, Ms Balic, you did not start selling shares in Carillion as early as Standard Life did. Were you also scratching the surface—as Mr Stirling put it—at the end of 2015 and into 2016? Do you have some of the same concerns that Standard Life did? Maybe we can start with you, Mr Murchison.

Murdo Murchison: Sure. Thank you. Our approach is very much to spend a lot of time in the audited financials. We rely very heavily on the historic accounting record of the companies we invest in and typically that is a very good guide to what is going on. We would argue that in this case it clearly was not a good guide to what was going on. That is where we spend the bulk of our time.

Certainly I would echo the point that was made. The issue with the balance sheet was self-evident to most investors and, certainly by 2017, was very much reflected in the valuation of the stock. For us, taking a longer-term perspective—we are long-term investors—that was an issue we had identified and were aware of. We would not have been surprised if the company had come to the market to seek fresh capital.

The two issues we were not aware of and were not evident from the financials were first the poor operational performance, in terms of contract management and so on, bidding for contracts at low prices, and, secondly and critically in this case, the aggressive accounting that has come to light. As a third party observer of publicly available information, those issues are quite difficult to identify from a distance.

Q1005 **Chair:** Mr Murchison, you said that the audited accounts are usually a good guide to what is happening but they were not in this case.

Murdo Murchison: Yes, correct.

Q1006 **Chair:** What was wrong with those audited accounts?

Murdo Murchison: If you have a company that burns through £850 million of cash in one year, having apparently for many years generated reasonable amounts of cash flow—it was not perfect by any means—then



HOUSE OF COMMONS

there is clearly a case to answer. The notion that that all happened in the matter of a couple of months in early 2017, to our mind, is incredible. There must have been prior issues that were not presented to investors that then caused that quite calamitous collapse. The scale here is extraordinary. Carillion, we would argue and certainly hope, is an exception to the general rule that an investor can rely on audited accounts.

Q1007 Chair: The claim by KPMG, the external auditors, and by the Carillion board that these problems emerged in short order between March and July, when they did their profits warning, does not seem believable to you, Mr Murchison?

Murdo Murchison: No. We certainly did not think that at the time. Straight away there was something very odd going on. It was a big red flag. The evidence the Committee has produced—notably the FTI Consulting report—is very strong evidence that the issues here were pre-existing over a number of reporting periods.

In fact, again, going through the minutes that have been produced—it is not often we get to see these—the minutes from the board on 22 August make it quite clear that these were pre-existing issues. You had a company with a culture of meeting the numbers and, whenever you have a “meeting the numbers” type culture, then people will tend to push the accounting and push the cash flow management to hit short-term targets. On the basis of the evidence that has been presented to us over the last couple of months, it seems very clear that there is a strong case to answer here.

Q1008 Chair: Amra Balic, what are your thoughts on when things started to go wrong and what engagement did BlackRock have with the board?

Amra Balic: It is important, maybe, to highlight that BlackRock had a long position in Carillion but also a short position. The long position was held through our index tracking strategies. What that means in practice is we are tracking an index and we are investing in a stock for as long as it is a constituent of a certain index. The reduction in our position started when the share price started going down and the company was no longer in certain indices.

My portfolio managers, my colleagues on the active management side, did not have a long position in Carillion. For as long as I have been at BlackRock, BlackRock on the active side did not hold Carillion stock. That is purely as a result of a view on the company and the whole industry. We felt there were a number of real questions around fixed contracts, variable costs, large levels of debt and the fact that the company had grown through a number of acquisitions. Our active portfolio managers did not see the industry—and Carillion in particular—as an attractive investment proposition.

Q1009 Chair: What engagement did you—



HOUSE OF COMMONS

Amra Balic: On engagement, the reason I think it is important to explain is that they have however met the management teams over a number of years. This is the information I have from my colleagues. They felt that the management teams—we are talking about different management teams here—were overly optimistic. The view was that they felt they could deal with a number of challenges in relation to the balance sheet and the level of debt.

My team meets with the board and we have had a number of interactions with the board members, most recently in 2016 and 2017. That was around executive pay. We received a letter from the company's remuneration committee looking to allow for more opportunity and a larger bonus for the executives. We categorically said no to that.

Chair: We will come on to some of those issues shortly.

Amra Balic: Sure.

Q1010 [Click or tap here to enter text.](#) **Chair:** Can I ask you, Ms Balic: is it usual for investment funds to both long and short the stock of a company?

Amra Balic: Yes. Investment houses like BlackRock manage money on behalf of our clients. That is the only thing we do. Everything we do, we do on behalf of our clients. We manage money for a number of different clients and for those different clients we help them and we support them in achieving their financial goals. What that means—

Q1011 **Chair:** Some clients wanted to—

Amra Balic: I am coming to that. What that means in practice is that you can come to BlackRock and say, "I want to invest in a low-cost product that is tracking the index, which is diversified and transparent", and we can help you with that, or you, Frank, can come in and say, "I have a greater appetite for risk". We can maybe invest in a fund that can short stock. We can do that for you without any questions in relation to conflicts because the people who are helping you and the people who are helping you, Frank, are different people. That is how the industry works. Absolutely we can have a long and short position and very much make sure there are no conflicts when managing funds for different clients.

Q1012 **Chair:** Presumably part of the reason for going to a company like BlackRock, or indeed Standard Life or Kiltarn, would be to get advice. Wise as Mr Field and myself are, perhaps our expertise is not in investing in the stock market. We might come to you, Ms Balic, and say, "We are not sure which the best companies are to invest in and we don't know if Carillion has a good future or not. We don't know whether to long or short that particular stock". What was BlackRock's advice during 2016 and 2017?

Amra Balic: Advice to whom?

Q1013 **Chair:** To your clients.



HOUSE OF COMMONS

Amra Balic: It would depend on the client's financial goals. The vast majority of the clients whose money we manage are pension savers and they have their own views on risk and return appetite. Trustees who are taking care of pension pots—

Q1014 **Chair:** I understand that if somebody wants a tracker fund and Carillion was in that index then people would invest. I am just asking what your advice would be. Would your advice have been to invest in Carillion or not?

Amra Balic: If you are tracking an index you have to invest in Carillion.

Q1015 **Chair:** I know that.

Amra Balic: On the active side, that is the nature of active business. Portfolio managers take a view based on, as some of my colleagues here have pointed out, publicly available information. They form a view whether a particular stock is an attractive investment or not. In the case of BlackRock, they took the view that it is not.

Q1016 **Chair:** Mr Stirling has already answered this but could you just confirm when you divested of Carillion stock, Ms Balic and Mr Murchison?

Amra Balic: The divestment started to happen as the share price was going down and there were changes in certain indices. As I explained in the letter in response to your letter from the end of January, as, for example, they stopped paying dividends. It was automatically removed from certain indices. That is where our reduction in position started.

Q1017 **Chair:** In 2016 you still held substantial shareholdings?

Amra Balic: In 2016 a long position was held by BlackRock in line with indices that we were tracking.

Q1018 **Chair:** From the summer of 2017 there were no longer dividends being paid, but in your funds that did not require dividends were you still holding Carillion shares?

Amra Balic: Yes, but the holdings had gone down as the share price was going down.

Q1019 **Chair:** Were you a shareholder right until the collapse of Carillion?

Amra Balic: Yes.

Q1020 **Chair:** Thank you. Mr Murchison?

Murdo Murchison: We first started buying Carillion shares for our clients in December 2011 and over a number of years added to those holdings, primarily as a result of the growth of our own business and the attraction of new clients. After the profit warning in July, we reviewed the case as a matter of urgency—obviously in the light of the fresh information—and took the decision to start selling on 3 August 2017. We sold down our position over a matter of months and the final sale took place on 3 January 2018. The last share was sold then.



HOUSE OF COMMONS

Q1021 **Chair:** Just a final question to Ms Balic. Did any of your funds benefit from the collapse of Carillion?

Amra Balic: At BlackRock, everything we do we do on behalf of our clients. Net of fees, BlackRock did not benefit in any shape or form from—

Q1022 **Chair:** Did your clients benefit?

Amra Balic: Clients who were invested in funds that held short positions benefited from what has happened.

Q1023 **Chair:** Overall, by how much?

Amra Balic: The reported figure is around £36 million.

Q1024 **Chair:** Over what time period was that?

Amra Balic: We have had a short position since 2013. It was not over the last six months, as I have seen reported.

Q1025 **Chair:** That £36 million is between 2013 and January 2018?

Amra Balic: Yes.

Q1026 **Peter Kyle:** Did the profit warning of July last year and then the £845 million provision come as a surprise to you, Mr Murchison?

Murdo Murchison: Yes. The context here is that over a number of years the management have presented to investors, and to other external parties, the picture of a business that at its core was highly cash generative on the back of long-term, stable contracts and a secure customer base, notably the UK Government. The construction side was almost an ancillary, if you like, to that core. There was a consistent message presented of a business that was relatively low-risk. The financial history over a number of years suggested that was a reasonable case because through the financial crisis they performed quite well compared to a number of their peers; their margins were attractive relative to peers and so on.

When the £845 million provision arrived—and particularly when we saw the scale of the losses against particular contracts, very large contracts relative to the size of the company—the scale of those exposures had not been disclosed at any point in time. With the overlay of the peculiarity of working capital management that seemed quite unique, shall we say? We were extremely surprised.

Q1027 **Peter Kyle:** Even though other investors were divesting?

Murdo Murchison: Yes.

Q1028 **Peter Kyle:** You were not questioning why that was happening to the extent it was?



Murdo Murchison: The context here for us is that we were clearly aware of other people divesting and we are always interested when that happens, but it was rational to understand that on the basis of the information we had in terms of a balance sheet concern. To be clear here, any notion that Carillion had a pristine balance sheet or pristine cash flow is not the case. The market had a concern about the balance sheet that was reflected in the valuation. The market had a concern about the dividends, which you may come on to.

It was not as though we were buying a company we thought was amazing but our whole investment style, which is a value-based style, is to buy companies that may be trading through a difficult period perhaps for one, two or three years, support them with additional capital if necessary—certainly in this case we thought it might be necessary—and then, from a long-term perspective, everyone benefits. Does that help?

Q1029 **Peter Kyle:** That is helpful. Mr Stirling, you had already started divesting then. Did it come as a surprise to you, that period in July last year?

Euan Stirling: I would agree with Mr Murchison in terms of the scale of the profits warning. That was definitely a surprise. But in our view these things do not happen over short period of time, and it was the risk of a significant warning coming at some point that was causing us to divest the shares at an earlier point. Different investors have different risk tolerances. Different investors take different judgments based on the evidence as it presents. Our view was that the rising risk, the rising debt, the complexity and the repeated desire for acquisitions—I think that culminated in the attempt to merge with Balfour Beatty in 2014—for us, were warning signals, despite the operational attractions of the last. We felt that there was something likely to happen, and a potential capital raising that could have been a painful experience to go through as a shareholder.

Q1030 **Peter Kyle:** The 2016 annual report and accounts painted quite a rosy picture of the financial situation. It was only a couple of months later that there was the profit warning. Is it common in your experience to have such a rosy picture deteriorate so quickly?

Euan Stirling: This almost characterises the relationship we had with the management team. There was a gloss to the presentations that we felt did not reflect the true business circumstances. When we looked at the 2016 results—it is worth remembering that we were not as significant shareholders at that point; we had a much smaller holding and a lower financial interest—the picture that was painted on perhaps the first couple of pages of those results was not supported by the information that lay deeper into the accounts. For example, the use of reverse factoring to support a stated debt level that flattered the company's financial position was revealed later in the accounts.

Q1031 **Peter Kyle:** Mr Murchison, why did you not see beyond the gloss?



HOUSE OF COMMONS

Murdo Murchison: First of all, let me reiterate what I said. We did not have a rose-tinted view of where this business was. The debt development in 2015 we felt was a concern and 2016 was another year of disappointment. We looked at the balance sheet and were not happy with where the debt was going. We looked at the working capital and were not happy with where debt was going. It was part of the reason we were very happy to vote against management in terms of remuneration.

Again, I would argue that at that point, on the basis of the disclosed financials, the key issue was a capital shortage that could be solved by an issue of fresh equity. At that point, one would have thought that net debt would be lower, the working capital management would be improved and you would have a business that could trade its way through into a profitable long-term future. Again, I would reiterate that the financials showed issues. Those issues were clearly reflected in the valuation of the stock. Therefore the question is whether, on a three to four-year view, you are prepared to take on that risk. At that point we thought it was quite reasonable.

Q1032 **Peter Kyle:** Did not the huge amounts of goodwill give you cause for concern?

Murdo Murchison: We always look at goodwill. We invest globally and our typical approach to goodwill is to basically discount it quite heavily. Goodwill is typically the result of past management actions to overpay for assets and we saw that clearly here with McAlpine, for example. The question then is: is the market paying up for that goodwill? Again, it was discounted in the valuation. This is not a capital-heavy business. The goodwill in this case was not something we put a lot of weight on. In fact we discounted it very heavily.

Q1033 **Peter Kyle:** Mr Stirling, just going back to the previous question: are there any other examples you can give us where a rosy picture of a significant company deteriorates so fast? Is it common in your world?

Euan Stirling: I would struggle to think of a specific example that would be relevant to the case of Carillion, but I am afraid that the contracting and the building contracting industry is famous for being deeply cyclical. It has very high highs and very low lows. It is often characterised by very thin margins. Every economic cycle and every market cycle we do see casualties in that industry. It often appears as a significant surprise at the time because the financial statements have been made to reflect a much more optimistic outlook for the company.

Q1034 **Peter Kyle:** This is exceptional, in your view?

Euan Stirling: It is exceptional in its scale but it is not exceptional in the industry.

Q1035 **Peter Kyle:** Finally, another investor did tell us in written correspondence that they "may have been willing to add further capital to the company after the 10 July warning". How do you feel about that? Are



HOUSE OF COMMONS

there any circumstances where you feel you may have been in the same situation, any of you?

Euan Stirling: We took the view when we started to divest the shares that a capital raise would be required and would be likely. We did not feel that risk had been reflected in the share price. I think the situation is slightly different for other shareholders.

Q1036 **Peter Kyle:** Finally, Mr Murchison, is there any learning from this that you feel is impacting the decisions you are making now, going forward?

Murdo Murchison: Our approach is very firmly based on very detailed analysis of historic financials. This is the case not just in the UK but globally, whether in Japan, the US, Germany or wherever. I would argue that in most cases that is a perfectly reasonable approach to take. Periodically you will find these types of situation evolve and that is one of the reasons we run a highly diversified fund. We have around 90 holdings in our portfolio.

One thing would be completion accounting. Around 40% of the revenues here were completion accounting. One has to be extremely cautious and generally we are. Typically, I would echo the comment about this industry being notorious for periodic blow-ups. My frustration here is that you do have a number of years of accounts where it appears this business was trading not just adequately but, at a margin level, trading very, very well. We are frustrated with that.

There are a couple of things I would pick up on. I am concerned about the role of non-executive directors because, in this situation, it is not clear to me they have been able to exercise any effective check on the executive management team. It appears that they were hoodwinked as much as anybody else. That is a serious issue.

The second issue for us is simply disclosure. To be clear, if we knew the scale of the liabilities here, not just when the contracts were not working but even when they were apparently profitable, we would have asked very different questions of the management team and expected very different things. I am unhappy with the level of disclosure provided here. Even the timeliness of disclosure I am unhappy with. Certainly we are very patient and long-term, but I wonder whether in this case we were too patient.

Q1037 **Frank Field:** You have each presented a different sort of model about investing. Amra, your organisation did both short and long-term. Murdo, in a sense, your organisation would back a company that needed capital to see it through. Euan, you saw the writing on the wall rather quickly and got out. I am wondering what the relationship is between you and how you conveyed that message. Also, there were these audits being done telling the world it was all right and yet you were making different judgments to the auditors. Amra, starting with you, do you often find yourself in a position where your own intelligence is making a different



HOUSE OF COMMONS

decision to what the auditors are trying to tell the world?

Amra Balic: As an investor, we make our investment decisions and conduct our stewardship activities based purely on publicly available information. In this case this was a company that was solvent. Not just that, it had audited financial statements that gave investors comfort it was a going concern. There was also a chairman's statement and a corporate governance statement, at the front of the annual report, painting a good picture. Going back to the earlier question about whether we were surprised, we were surprised. I think everybody was surprised.

Q1038 **Frank Field:** Do you think you were misled?

Amra Balic: At the time, before the collapse was announced, we did not feel we were being misled.

Q1039 **Frank Field:** Looking back, do you think you were misled?

Amra Balic: Having said that, with hindsight, a lot of new information has come out, pretty much since the beginning of your work. The board and the management have some questions to answer. That is why we think your inquiry and your work is absolutely critical here, to find out what has happened.

Q1040 **Frank Field:** Amra, what about the auditors? Murdo just said that he did not think the non-executives were worth a pinch of salt. They were unable to analyse information and govern the organisation. They could use a cover while the auditors were telling us it is all right.

Amra Balic: Again, I will reserve judgment until we have a full picture. I would just refer back to my earlier statement that at the time, before the collapse was announced, going back two years or even last year, we did not feel we were being misled.

Q1041 **Frank Field:** But now?

Amra Balic: We are clearly extremely disappointed with what has happened here.

Q1042 **Frank Field:** That is one way to put it.

Amra Balic: It is an understatement.

Q1043 **Frank Field:** Murdo, what about you? You are a company that does some heavy lifting in capital because you think the longer-term is okay. Do you feel you were deceived?

Murdo Murchison: I am extremely frustrated with the audit performance here. I think that is a reasonable position to take. We rely heavily on audited financials. The disclosure of minutes, the disclosure of question marks over whether this was sloppy accounting, aggressive accounting or very aggressive accounting, none of these things should ever be associated with a healthy audit that serves the needs of external parties. It is clear that investors have lost a lot of money here,



HOUSE OF COMMONS

pensioners have lost a lot of money, suppliers have been compromised and the folks closest to the scene of the crime, should I say—maybe I should withdraw that. On the basis of the information we have, there is at least a case to answer. The folks closest do not seem to have any liability.

Picking up on a question or a comment you made, one thing I would look at much more closely today is the tenure of auditors at companies. Clearly, in retrospect, the fact that KPMG had been with Carillion since 1999—

Q1044 **Frank Field:** There are also so few companies to choose from, are there not, Murdo?

Murdo Murchison: There are.

Q1045 **Frank Field:** The top four have sticky fingers all over this poor company.

Murdo Murchison: That is a broader question for this Committee to consider, the lack of choice—

Q1046 **Frank Field:** Do you think they should be broken up? Come on.

Murdo Murchison: You want me to answer? There appears to be a lack of competition in a key part of the financial system, which periodically causes a lot of other participants in that system a lot of trouble. Therefore I would like to see more competition, shall we say.

Q1047 **Frank Field:** Brilliant. Euan—in my little session, if I may—you were spotting that the ship was going down quite early. You met the chairman, Mr Green. Is that right?

Euan Stirling: That is correct.

Q1048 **Frank Field:** How did those conversations go? Did you think you were talking to somebody who understood what you were saying?

Euan Stirling: We met Philip Green twice, in 2014 and 2015. At that time I do not think it was evident that the ship was going down but it was listing slightly, perhaps, to starboard.

Q1049 **Frank Field:** You were thinking about disinvesting?

Euan Stirling: Yes, that is correct. What we expect of non-executive directors is a degree of support, guidance and mentoring but also challenge to the executive teams. We felt that the non-executives' support was definitely there for the strategy and the execution of that strategy but perhaps the challenge was lacking, which gave us the firm opinion that, whatever we were saying to the company, either executives or non-executives, that strategy was going to be pursued for a number of years to come. We were dissatisfied with that, particularly in light of the rising risks.

Q1050 **Frank Field:** Can I just ask one last question? Do you think that was



because they did not understand their role or they were incapable of understanding what you were telling them?

Euan Stirling: That is a question for them, unfortunately. We do not get sufficiently deep insight to be able to answer that directly. The one thing I would point back to is that the complexity of the business was rising all the while in a bid to trade their way out of their debt issues. The strategy seemed firmly pointed at rising turnover rather than necessarily rising profitability or rising cash flow.

Q1051 **Frank Field:** Murdo has told us that the company wrapped themselves in the auditor's report to show they were as white as driven snow. Euan, what I was trying to get from you was: here you are, a really significant investor who is talking to the chairman saying that you are getting out. Did he give you no idea he was taking this back to the board?

I will not use the phrase, because it is unparliamentary, but I would be absolutely worried beyond belief, having a conversation with you of that nature as chairman of a company. I would put it on the board papers for the next meeting to say what you were telling me and maybe invite you along to tell the rest of the crew.

Euan Stirling: We do know that some boards do that, invite shareholders to board meetings. It happens rarely but they also invite sceptical analysts from the investment community. I am not aware that that happened at Carillion. Our dealings with the company suggested a confidence in their approach that was not necessarily supported by the facts as we identified them.

Frank Field: That is another polite way of putting it. Thank you very much.

Q1052 **Stephen Kerr:** Can we speak a little more generally about stewardship and investment, particularly investment institutions? What do you do as institutional investors to monitor and engage with the companies that you invest in?

Euan Stirling: As I mentioned earlier, it is an integral part of our approach. We would aim to engage with the executive team very frequently and the non-executive team less frequently, depending on circumstances.

Q1053 **Stephen Kerr:** Talk a little bit about the circumstances in which you would become more engaged.

Euan Stirling: Where we spot dangers or difficulties or, where there is a material issue that has arisen, we would want to investigate that with all the different layers of management, to make sure the structures we believe are in place are functioning properly and they are effective in establishing whether the company is pursuing the right strategy.

Q1054 **Stephen Kerr:** Is there a level of investment at which you are particularly willing to become more engaged with those danger signals or



is it across the board?

Euan Stirling: It is across the board but your question is an interesting one because there is a question of materiality. We do invest across a huge number of companies globally. We have limited resource so we need to concentrate that resource where we think it will be best used and most effective. Where we have the biggest holdings in companies, or where we have identified particular issues, that is where we will focus our attention.

Q1055 **Stephen Kerr:** Is that engagement driven by what you perceive to be the nature of the board?

Euan Stirling: In some cases, yes. If there is a fundamentally strong business that is being mismanaged by the board and it is the board's responsibility to manage then yes, we will engage.

Q1056 **Stephen Kerr:** Again, just summarise what kind of engagement that would be, directly.

Euan Stirling: It would be direct engagement. We would ask to speak to the executive team in the first instance because they are always closest to what is going on.

Q1057 **Stephen Kerr:** Presumably, if they knock you back, if they don't seem forthcoming to have a meeting with you, that is a huge warning?

Euan Stirling: That would be a warning signal. That happens very rarely, I have to say. Companies do spend a lot of time meeting and preparing for meeting investors.

Frank Field: Also Select Committees.

Euan Stirling: Indeed. The share price of a company is often seen as a barometer of its success or failure. If a management team can act in support of the share price, they often will do.

Q1058 **Stephen Kerr:** How far do you lean in to the actual decision-making in businesses?

Euan Stirling: At a high level, we do lean in. We are not in place and we do not have the resource or the expertise to micromanage companies but we are very interested in the way that strategy is formed at board level, and we are very interested in the way that strategy is pursued and what the financial consequences of that will be, whether it is rising or falling debt, rising or falling turnover, or rising or falling profitability.

Q1059 **Stephen Kerr:** How effective has your institution's engagement with companies been, in your view? Do you have examples—anonymised if you wish—where your proactivity has been beneficial to the business involved?

Euan Stirling: Companies generally do listen. We look to have a constructive relationship with them. It is not adversarial. If it reaches the



HOUSE OF COMMONS

adversarial stage we know we have a problem. We hope and believe, at the outset, that it will be a constructive relationship and we do look for companies to respond to our concerns. In some cases we have found that they will adapt remuneration plans, they will bring more diversity and different experience onto the board or they will put in place or accelerate succession plans; all of these.

Q1060 **Stephen Kerr:** Does it frequently get to the point where you vote against things as a loaner?

Euan Stirling: It can do but it suggests almost that the prior engagement has failed. We would prefer not to reach that stage but it is a useful sanction to have.

Q1061 **Stephen Kerr:** Yes. Mr Murchison, the same series of questions in terms of your monitoring and engagement with the companies you invest in.

Murdo Murchison: It starts with a proxy vote. We vote in all our proxies for all the companies we are exposed to. For example, last year in over 100 proxies we have voted against management on approximately one in every two occasions on at least one item on the agenda. We are quite happy to vote against.

Q1062 **Stephen Kerr:** In one in two AGMs you at least once voted against.

Murdo Murchison: At least once, often with regard to their seeking authority to—

Q1063 **Stephen Kerr:** That is not a policy, is it?

Murdo Murchison: It is not a policy. We do not target that.

Q1064 **Stephen Kerr:** You do not do it deliberately? Warning shots?

Murdo Murchison: It is an outcome. Oftentimes management may be seeking powers that we think are too broad to raise capital at potentially diluted terms. Often remuneration is a big issue and it certainly was the case here with Carillion. We view the proxy voting as a very important part of our process of holding management to account.

Q1065 **Stephen Kerr:** Are there triggers that will get you more involved in the affairs of a company in those areas?

Murdo Murchison: It is an interesting question. It does relate to the Carillion experience a bit. Oftentimes your engagement with management goes up naturally when there is a major deal, acquisition or capital-raising. For example, there have been two reasonably sizeable mergers in the UK in the last couple of years that we voted against. That gives you an opportunity for engagement because management are coming to you and they need your vote, so you have a degree of influence.

In the case of Carillion, where one might say there was an element of drift—that would be a kind way of putting it—when things are slowly but surely moving in the wrong direction. The last big acquisition was in



HOUSE OF COMMONS

2011. It is a bit more difficult to raise the stakes, absent the catalyst to do so. You can vote against remuneration and you hope management take that on board and move in the right way, but unfortunately in those cases of drift it is inherently more difficult to engage.

Q1066 **Stephen Kerr:** That is about the nature of the people you are dealing with on the board, I take it.

Murdo Murchison: Yes, and just the opportunity. As I say, management tend to be most engaged with shareholders when they want something from them. That is a vote in favour of something or other. At that point you have leverage. It is quite difficult with a dispersed shareholder base to exercise leverage as a single shareholder. For example, the vote on remuneration here was passed by 80% of the shareholders on a 50% turnout. Most investors in Carillion at the time, on the basis of the way they voted on remunerations, seemed quite happy with management. We were not.

Q1067 **Stephen Kerr:** Is there a threshold of your exposure to a business that drives your proactivity? How far does that go in terms of leaning in to strategic decisions that are being made by a board?

Murdo Murchison: There is no threshold. We would argue that if you are a shareholder in the company you are an owner of the company and, therefore, you have a duty to act in your own clients' interests and in the interests of the company. You should exercise your vote even if you only have 10 shares. You have to think about it and do the right thing. Clearly how much you own will determine to what degree you are listened to, but that is a different thing. You have to vote your shares irrespective of the level of ownership.

Q1068 **Stephen Kerr:** Ms Balic, would you like to comment on these issues?

Amra Balic: Yes. Stewardship is very much key to our investment approach. As our index book of business has grown, the role of stewardship has grown as well. Because we cannot sell and walk away, we are invested in these companies for as long as they are on the index. That puts us in a key position to work with companies on the topics that are important for their long-term success.

Q1069 **Stephen Kerr:** In your own principal statement you talked about seeking to engage in a constructive manner.

Amra Balic: Yes, absolutely.

Q1070 **Stephen Kerr:** That word "constructive" keeps coming up. What does it mean for you?

Amra Balic: From our perspective, certainly, because we cannot sell and walk away, we are going to be at the table year after year. The starting point is—

Q1071 **Stephen Kerr:** "At the table". What does that mean?



Amra Balic: At the shareholder meeting. Every year we will be involved.

Q1072 **Stephen Kerr:** At the AGM?

Amra Balic: At the AGM, yes. What that means is that our starting point in those cases where we have identified issues is to be constructive, raise them with the management and try to give management time and opportunity to address these concerns. Ultimately, if that engagement does not work or we do not see progress because some things will take time, we will use our vote.

Q1073 **Stephen Kerr:** You did say that. You said that you are patient with companies but your patience is not infinite.

Amra Balic: Absolutely. Our patience is not infinite. We want to see progress. If we do not see that progress then we will be using our vote as a way to express our—

Q1074 **Stephen Kerr:** How far do you take your engagement, though? There appears to have been a lack of engagement with Carillion on your part.

Amra Balic: In terms of Carillion, because I represent the investment stewardship team, my team has had a number of meetings with the board since 2014. The most recent conversations were around executive pay, which I—

Q1075 **Stephen Kerr:** What year was that?

Amra Balic: The letter we received in December 2016 and then engagement was early last year. The meeting and the response we gave them were in early February 2017.

Q1076 **Stephen Kerr:** Not about the performance of the business as much as about the remuneration?

Amra Balic: Correct. Thinking about some of the information that has come out more recently, and looking at minutes from the board meetings in July, it seems that the board was thinking again how to remunerate executives rather than what was going on with the business, so I think there is definitely too much focus at times at the board level around rather than—

Q1077 **Stephen Kerr:** They were very handsomely remunerated. We had a fairly detailed description of that previously. What about the engagement with the board in terms of the performance of the business, especially in relation to this £800-plus million of a write-down? What was your engagement at that point?

Amra Balic: We have not spoken to them past the first quarter last year so we have not—

Q1078 **Stephen Kerr:** What was your shareholding at the time of this write-down?



HOUSE OF COMMONS

Amra Balic: Our shareholding was—I would have to double-check this figure—around 8 point something per cent. That was the highest figure.

Q1079 **Stephen Kerr:** Quite a bit.

Amra Balic: Yes, absolutely.

Q1080 **Stephen Kerr:** Other institutional investors were picking up the phone and saying, “We have to speak” and were being rebuffed, frankly, trying to set up a series of meetings in one case but you did not pick up the phone at all.

Amra Balic: Because the colleagues on my side had an opportunity at that point to sell stock and walk away. We did not. So that—

Q1081 **Stephen Kerr:** But that would have meant they would have picked up the phone quicker.

Amra Balic: Yes, but I think that there were a number of things that were unravelling at the time and we would have—speaking with them first—this quarter if it didn’t go the way it did. What I want to highlight is the stewardship also needs to be understood in the context that we are dealing with publicly available information. Stewardship cannot be seen as panacea for everything else so that other things are going wrong.

Q1082 **Stephen Kerr:** In your principal statement you talk about stewardship in the context of being engaged and being constructive. I would suggest that that would also involve a constructive tension. You need to know the board. You need to speak to the board about things other than their pay, in order to get that kind of stewardship right. Agreed?

Amra Balic: Absolutely.

Q1083 **Stephen Kerr:** Did you have that right at Carillion’s?

Amra Balic: We have spoken to Carillion’s management and—

Q1084 **Stephen Kerr:** Not the board? Did you know the board?

Amra Balic: Yes.

Q1085 **Stephen Kerr:** Can I ask similar questions to Mr Stirling in relation to the Carillion board? You did seek to meet with them after the write-down. What was the next level of discussion?

Euan Stirling: It was one discussion with the interim chief executive, Mr Cochrane, and that was it. We did not meet with the non-executive directors at that point.

Q1086 **Stephen Kerr:** He could not give you satisfactory answers at that time.

Euan Stirling: If you remember, at that point we had almost entirely divested from the shares and we were not inclined to buy any more at that point.

Stephen Kerr: Thank you.



HOUSE OF COMMONS

Q1087 **Peter Kyle:** Just to follow that, Mrs Balic, your relationship with Carillion was schizophrenic, though, wasn't it? You had some clients that were shorting. You had some clients that were doing long-term investments. You saw your role as being hands off and just doing as your clients instructed. You were not taking a view as to whether Carillion was well managed or not. You were just doing what your clients wanted to do with the stock.

Amra Balic: In terms of what our clients have invested in, which is a decision made by our clients and board of trustees.

Q1088 **Peter Kyle:** I need to clarify the question I think. Earlier you were saying that you were not advising your clients, which means you did not really have a view as to how Carillion was being run. You were just doing what your clients were asking to do. How can that lead to a good relationship in terms of encouraging good stewardship?

Amra Balic: It was quite a different case. What I was saying is that we can manage money, invest money, for different clients based on their aim, what they are looking to achieve and what financial goals they are looking to achieve. The vast money that we manage is pension savers. When our clients come to us they typically have a view on how they want to invest money. I was trying to explain how industry worked from the perspective of conflicts.

What we are talking about here is our engagement with Carillion from a stewardship perspective. When we talked to Carillion we talked to Carillion from our view of what we thought were the key challenges for the business. We also talked to Carillion when the board or the management wants to come to talk to us and we do not take any particular clients into account. We look at it on the basis of publicly available information and form our view in terms of what we think is important to discuss.

Q1089 **Peter Kyle:** Thank you. Mr Murchison, you said in written evidence to us that, in certain circumstances, Kiltarn may deem it appropriate to engage with the company's management and/or board with a view to influencing the company's governance or business practices. In this case you did not. In what circumstances do you do that or have you?

Murdo Murchison: If one looks at the circumstances of this case, we had a process and the stewardship talks about this. You need a process to know when to accelerate your level of engagement. It started with voting against remuneration over a two-year period. We looked at the balance sheet and there was a reasonable concern that the business required fresh capital. I was intrigued to learn that in fact the company was actively exploring doing so, because we certainly were not aware of that. My view in this particular situation was if by the interim stage we did not see evidence that the cash flows were improving, the balance sheet were improving, then we would have a much more serious level of engagement because then, looking back, you would see that the dividend



HOUSE OF COMMONS

payment that was announced in March 2017 was a very poor use of capital. We would much rather see the business—

Q1090 **Peter Kyle:** Thank you. Can you give us a clear example where you have, in your mind, been assertive?

Murdo Murchison: Yes, I could. I would not be prepared to mention particular names but, for example, we have a large number of Japanese holdings where there is a structural issue in Japan, in terms of persistently low levels of return for shareholders. On a number of occasions there we have been quite happy to write to the board and note—and this is a big issue in Japanese culture—“Unless we see improvements we will vote against re-election of all board directors”. We are certainly quite happy to take a more adversarial stance but I think that it is necessary to hold managers to account.

Q1091 **Peter Kyle:** Thank you. Finally, Mr Stirling, in general terms we have heard in this inquiry from the FRC. We have heard from regulators. We have heard from auditors. Nobody says they either have the power or the inclination to be assertive with a company when things seem to be going a little bit wrong. To what extent should investors be actively seeing what is happening beyond the headline numbers that are released, getting to know the characters, getting to see what is happening in the company tallies to the reality and just to be an active partner in the running of a company?

Murdo Murchison: That is a very good description of what we seek to do but we are resource constrained. We do put a lot of resource behind that. We do meet hundreds of companies on that basis every year. We do attempt to do more than scratch the surface and get to know the characters, in order that we can form an opinion of the likelihood of the predictive returns emerging from the company. That is always the clear objective; working out what the long-term future of the company is likely to be. There are so many factors that can affect that that we attempt to establish a view on as many as we can. The management team meeting the board members is a clear part of that.

Q1092 **Antoinette Sandbach:** I am moving on to remuneration and we have had a little bit of evidence on that already. Kiltearn wrote to us and said that you took the view that Richard Howson’s proposed total remuneration increasing by 17.7%, relative to the prior financial year, while Carillion’s net income had fallen by 7% was, in effect, not justifiable and you used your votes to support that. You said in your evidence that you did not find Carillion’s explanation for the proposed increase reasonable. Why was that?

Murdo Murchison: Two or three things pointed to a remuneration framework that was not working for anybody. First of all, over the two-year period, the compensation had risen quite dramatically from around £1 million to £1.5 million at a point in time where the business was clearly going backwards. It certainly was not progressing. There was a



HOUSE OF COMMONS

complete disconnect between financial performance, which obviously as shareholders we are focused on, and remuneration.

There had been a failure to meet financial targets in both years but compensation was still being awarded on quite difficult to define non-financial measures, which give the board a great deal of freedom to pay what they want to pay. That is unacceptable by our way of thinking.

Q1093 Antoinette Sandbach: Given that 30% of the bonus and 50% of the LEAP award depended on earnings per share, do you think there was an incentive on the directors to skewing the company towards raising debt rather than equity issues?

Murdo Murchison: Yes. What is interesting in this case is that—and you are absolutely right—there was wealth proportions but, even with that, they failed to reach the fairly easy EPS and cash conversion targets. I think there are two issues here; one is the levels that were targeted but secondly, EPS; particularly adjusted EPS because oftentimes EPS, after all the bad stuff is taken out, is a very poor measure of the health and profitability of a company.

We would much prefer longer term targets that look at returns on capital for example, have a longer term perspective. Bonuses are driven by short-term financial measures that appear to be good for shareholders but, for long-term shareholders, it can be very damaging and we tend to vote against them.

Q1094 Antoinette Sandbach: Ms Balic, BlackRock voted against the remuneration package as well. Are there any other reasons you would like to add to Mr Murchison's?

Amra Balic: We were supportive at the shareholder meeting in 2017. That was pretty much the last conversation that we had with the board and the remuneration committee around pay.

Q1095 Antoinette Sandbach: You were supportive?

Amra Balic: Correct. Yes, we voted for and I am getting to the point why. The letter that was sent to us described the plans that the board was putting in front of investors or consulting investors on that included further increases in bonuses, and we specifically felt that that is something that we could not support. They were also suggesting reduction in pension contributions.

That is one area that has been very important for BlackRock over the last 18 months. We felt that the pension contribution between executives and the rest of the workforce are totally out of sync and we were strongly, well, influencing companies to gradually start reducing that. They had made that change and we felt that they are moving in the right direction. When it comes to bonus we basically categorically just said "no" and the board came back in March and said, "We are going to take your view. We are not going to make any changes". Based on progress that they made,



HOUSE OF COMMONS

we have determined to be supportive, not because we think they are 100% in the right place, because we felt that we are moving them in the right direction.

Q1096 **Antoinette Sandbach:** What progress had they made?

Amra Balic: We felt that the pay is gradually coming down. We felt that—

Q1097 **Antoinette Sandbach:** The evidence is that the pay was dramatically increasing, as Mr Murchison had said. In a two-year period it had gone from just about a million to £1.5 million.

Amra Balic: Our view was that with the changes that they were proposing and the changes that we stopped, these payouts are going to start going down and they are not going to be potentially as high.

Q1098 **Antoinette Sandbach:** This was a time, also, when the pension deficit was increasing not decreasing.

Amra Balic: Yes.

Q1099 **Antoinette Sandbach:** Your vote did not reflect BlackRock's values in terms of reducing pension deficits.

Amra Balic: No. It is not about pension deficit. I was talking about pension contribution to executive teams for executive pay. It has gone down from 40% to 25%. When it comes within executive pay discussion, for us that was material change.

Q1100 **Antoinette Sandbach:** For Joe Bloggs that has, say, £5,000 invested in shares how does he get protection from excessive executive pay, if large investors are not exercising oversight in terms of the way that they are voting and looking at remuneration on company boards?

Amra Balic: We are voting against. We have voted also against board members. Last year every time we have voted against pay we have voted against the whole remuneration committee. Our policy and guidelines that are available on our website are very clear in terms of BlackRock views on pay and we are voting in line with our guidelines.

Q1101 **Antoinette Sandbach:** Mr Murchison, do you have a view?

Murdo Murchison: There are two aspects here. One is shareholders who vote, institutions that vote, and the many that don't vote at all and just ignore their responsibilities. I wonder whether greater disclosure on the part of the industry as to what votes they made during the year might be quite helpful to your point, so a client can see how the person in the institution, that is the steward of their capital, has acted on their behalf. Then I think they can make their own mind up as to whether someone is doing a good job or not. In general, I think one of the Carillion lessons is greater disclosure from the companies. I wonder whether greater disclosure from institutions might be something worth considering.



HOUSE OF COMMONS

Chair: It might be quite useful for this Committee as well—and I recognise that Standard Life did not have a vote at the last meeting—if for the last three or four meetings you could disclose to this Committee how you voted in all the votes that happened.

Q1102 **Antoinette Sandbach:** In terms of the bonuses, there was a clear change proposed by the Carillion board in terms of the clawback potential. Did any of you raise concerns about that shift in the clawback position for the bonuses?

Euan Stirling: No. It appeared to us to be a technical change that the company was justifying in increasing its ability to clawback bonuses from board members. The conversation that we had in respect to bonuses was the same as BlackRock. When the remuneration committee attempted to increase the maximum payout for the chief executive we pushed back quite hard on that as well, and the company then relented and went back to its original position.

Amra Balic: If I can just give a suggestion to the Committee. I think one area where the whole remuneration and executive pay can be strengthened is around clawbacks. What seemed to be the case is that the UK market has implemented clawbacks across the board but when it comes to the situations, like we are dealing here with Carillion—which is deeply upsetting for everyone involved, particularly the employees and pension savers—the clawbacks don't work out or there are legal issues in terms of implementation.

What needs to happen is the UK market needs to create a standard legal language around clawbacks that is equally applicable to every single company. Because we spent too much time realising that we are—

Q1103 **Antoinette Sandbach:** Ms Balic, sorry to interrupt you but is there an example elsewhere? Is there another country that does that and, if so, could you provide us with some examples of where other countries may impose that kind of clawback provision?

Amra Balic: I can, yes.

Q1104 **Chair:** Since what happened at Carillion, have you looked at the clawback arrangements for other FTSE 100 companies you invest in and whether other companies have clawback arrangements like Carillion had? Amra Balic.

Amra Balic: We look at clawbacks. What has come to my attention—and I can furnish you with more information after this session—is that what comes out is that information around when clawbacks can be triggered are not necessarily fully disclosed in a timely manner to investors.

Q1105 **Chair:** I recognise that is a question that requires quite a bit of detail in an answer, if you would come back to the Committee with some more information about that that would be very helpful, Ms Balic.

Amra Balic: Absolutely.



HOUSE OF COMMONS

Q1106 Frank Field: Can I ask all of you very quickly about comparison between how the House of Commons works and you work, because people might be slightly mystified if there is a company going over the cliff that you are voting against A? In the House of Commons if there is real disquiet about how a Secretary of State is running a Department a motion goes down to reduce their pay, and if that is passed they are finished.

Is the action by each of you, when you vote against remuneration at AGMs, flashing a red light to everybody else to say, "Look, this is the only thing we have power to do at AGMs other than turn the whole ship over. People ought to take note that we are now using this single power, the best power we have, to tell the world that we are deeply unhappy"? Would that be a fair way of describing it, Amra?

Amra Balic: We have started to take somewhat different view. We are holding board members to account for what they do. What has happened for a long time in the UK market is investors did not feel particularly comfortable voting against companies and pay. In particular, it was often a sign that they are not happy with the job directors were doing.

The corporate governance consultation that has just closed, last week, we focused very much our response—which is going to be publicly available this week certainly from the BlackRock side—is around the duties of directors, the importance of duties of directors and holding directors to account for what they do. I would say that holding directors to account is probably where investors need to be.

Q1107 Frank Field: The holding to account, in the final analysis, you vote against their pay finally if everything else fails?

Amra Balic: Yes, pay is.

Q1108 Frank Field: It is the final warning decision?

Amra Balic: Yes.

Q1109 Frank Field: Murdo, is that—

Murdo Murchison: For us it probably comes slightly earlier in the process, in that we typically find that senior managers react and respond to incentives and the way they structure their incentive programmes tells you an awful lot about their priorities. Typically, incentive programmes are designed to deliver the outcomes that senior management want and it is rare that you will find stretched targets that say they cannot meet.

You learn a great deal about the culture at the top of a business from the way compensation programmes are structured and it is, I would agree, a red light. It is an opportunity to engage with management as to how they run the business and why these targets are appropriate as opposed to other targets. We find that it is almost a mechanism where you can have a broader discussion about what is going on in the company.

Q1110 Frank Field: Euan. Sorry, can just Euan answer that and then back to



you.

Euan Stirling: Like Kiltarn and BlackRock we vote all the resolutions that we have our disposal through our shareholdings, and it is important that companies take notice of dissent votes when we vote against issues. In the UK we have just launched a public register of companies who received significant votes against to encourage them to take that more seriously. That should be helpful to us in influencing companies. We still find that some companies are quite happy with a 10% vote against either pay or any other resolution, so what we have as the ultimate sanction is the vote against the reappointment of specific directors and we do exercise that.

Q1111 **Frank Field:** Your register ought to be read by the Pensions Regulator.

Euan Stirling: Sorry, I missed it.

Q1112 **Frank Field:** Your register of warning signals ought to be a key document for the Pensions Regulator, in looking at whether this company is going to fulfil its pensions.

Euan Stirling: It is available to the public.

Frank Field: To her as well, sorry.

Chair: Antoinette Sandbach very briefly.

Q1113 **Antoinette Sandbach:** I want to clarify, Ms Balic, you said that you had spoken with Carillion's board or the remuneration committee. Can you just clarify, is the proposal that you voted for different from the one that they initially discussed with? In other words, were they asking for even more remuneration and you—

Amra Balic: Correct.

Q1114 **Antoinette Sandbach:** Therefore, could you write to us and tell us what the proposals originally were and what they then came back to? Thank you.

Amra Balic: Absolutely.

Q1115 **Chris Stephens:** One of the other issues that this inquiry is looking at is the culture of dividend payments. Can I ask each of you: did the growth in dividend payments up to 2017 influence your decision to invest in Carillion? Could we start with Mr Stirling?

Euan Stirling: The dividend payment is an important part of the return to shareholders from the earnings that are generated by a company, but it is completely against our long-term interests as responsible owners of companies to encourage companies to pay unsustainable dividends. It is as dangerous to look at them in isolation as it is to look at any application of earnings or cash flow in isolation. The way that we tend to analyse companies is to try to forecast all of the incoming profits and cash flow, and then work out what the company's needs will be to sustain their future. If product innovation is an important part of the company's future



HOUSE OF COMMONS

then we would want to see that that was adequately funded before a dividend was paid. That would be how we would work out whether a company strategy was sustainable.

Murdo Murchison: Two or three things: first of all, we are long-term shareholders. The notion that one would want to focus on dividends and receive dividends at the expense of the long-term health of the company is ridiculous. I was quite annoyed when I heard the evidence from the chairman suggesting that shareholders were demanding dividends or words to that effect.

Dividends are residual, after all the other liabilities, employees, pensioners, capital investment have been paid. Once you have worked out what is left then you can figure out whether you can pay a dividend. There is a cultural issue primarily in the UK and US corporate cultures where a lot of management teams believe dividends are their priority. That is their first call and that is not prevalent in Japanese or German corporate culture, for instance. I think that is an issue.

In this particular case, an additional factor is this desire to present to investors a company that was very cash generative and capable of paying out high sustainable dividends. They took a lot of pride in their dividend paying track record.

Q1116 **Chris Stephens:** Did that influence your company's decision to invest in Carillion?

Murdo Murchison: Did it influence? When we looked at the dividend we, again, looked at it and thought, "That level is not sustainable". When we looked at it the stock was yielding over 8%; relative interest rates are close to zero. In our analysis we baked in a dividend cut. When the market is telling you a dividend is not sustainable the market is usually right and, again, it is quite interesting in this context as to why the management were so optimistic about the business they were prepared to take a different view. Dividend is only one aspect of our assessment. Of more importance is the long-term progression in the assets of the business, the long-term progression in the earnings and the dividend is the residual from those two key inputs.

Amra Balic: We did not have an active position. All our holdings in Carillion were through industrial strategies and the fact that the company was in some of the industries that were directly linked to dividend payments. That is correct, but that has happened pretty much automatically but our team did not have an active position or active portfolio managers.

Q1117 **Chris Stephens:** What was the response of each of you then when dividend payments were suspended in July 2017? Can we start with BlackRock?

Amra Balic: What has happened through the products, index products that are directly linked to dividend payments, the company was taken out



HOUSE OF COMMONS

of the index and we had to reflect that in our holdings. Apart from that, we understand that the dividend payments is—maybe to your point—distributable; what is left rather than what the company's—

Q1118 Chris Stephens: Is it not the case the BlackRock started automatically divesting from the company once it learned that dividend payments were suspended? Is that—

Amra Balic: When the share price started to go down, yes.

Q1119 Chris Stephens: Yes, because that is a letter you sent to this inquiry is that when dividend payments were suspended you started automatically divesting from the company. Is that a policy decision that you make across the board?

Amra Balic: That is not BlackRock policy decision. Certain funds are managed exactly in the same way, so they are index tracking. Whatever happens with an index it is our duty to replicate that. Once the company was taken out of index we have to replicate that. It is not a policy decision.

Q1120 Chris Stephens: Is that not encouraging short-term profits at the expense of everything else? I think that is my concern, is that a decision to divest the company—and one of the factors being dividend payments—that BlackRock's policy, investment decisions, are short-term profits at the expense of everything else. Is that—

Amra Balic: I want to highlight that there were no decisions by BlackRock. We are simply replicating index because that is the nature of index tracking strategies. We are replicating what is happening in the index. It is incorrect to say that it is a BlackRock decision. The index funds that Carillion was part of, we are required to replicate and whatever happens with that position with the index we are required to replicate.

Q1121 Heidi Allen: A quick summary for me. It did make me smile, thanks, mentioning about the House of Commons. It did make me feel that it is a little similar and voting against is the end of the road, isn't it, when you have run out of options? It is quite similar here.

It strikes me that you all have had different levels of engagement with the board, presumably related to your levels of nervousness as to what was going on. It seems to me that Standard Life, it feels, were the most actively involved and, lo and behold, you pulled out the first. Can each of you tell me: what are the warning bells? You talked about too many acquisitions. It seemed like they were so hungry for cash flow, just acquisitions to keep going. What are the red warning lights that you would typically look for? Are they going to change going forward and your level of nosiness in a company and its stewardship, will that change as a result of what has happened with Carillion? Euan, perhaps to start.

Euan Stirling: Nosiness is an integral part again of our approach. Will that change? I don't think so. Will the warning lights change necessarily



HOUSE OF COMMONS

after this event? I don't think so. I was asked earlier about another example, and it has occurred to me now it was Balfour Beatty. It got into a very similar mess. The financial position was different. It was salvageable. It hadn't gone on. It hadn't perpetuated as long as Carillion's had: in exactly the same industry with a slightly different strategy with a better balance sheet, with a little bit more cash generation, and recognising the problems earlier than Carillion. I think that was absolutely key, and bringing in a new management team with a different strategy to rescue the financial position. It is not one particular factor that starts the disinvestment process. It is a combination of a number of them and it is only through nosiness that we are able to establish—

Q1122 Heidi Allen: What sorts of things are you talking about? What are the red warning lights for you?

Euan Stirling: It will vary from industry to industry. If we are looking at a very capital-intensive industry, which has not been investing in its plant and equipment, we will think there is a serious risk of their products becoming obsolete. In an industry like building contracting and the associated support services, we are conscious that the oscillations of the business cycle are quite extreme. If the company is not prepared for the bad years then it can lead to catastrophic failure. You do not have the cushion of comfortable profit margins. They are quite thin and they evaporate very quickly when the times are bad. The warning signs are particular to different types of business model and I think they will persist to be so.

Q1123 Heidi Allen: Your level of stewardship and the way your organisation interacted with their board, are there things you would do differently there?

Euan Stirling: We are looking to beef up the stewardship effort, even beyond what we do now, apply more resource to it. You may be aware that Standard Life and Aberdeen Asset Management merged in the middle of last year. That gives us a much more global footprint as a combined organisation. We are looking to apply stewardship to all of the investment teams as well as having a strong central stewardship effort to help direct those activities. As an organisation, we will have a substantially stronger stewardship effort and we will be able to be even more nosey than in the past.

Murdo Murchison: A couple of things. Our investment style means that we typically and frequently are involved with companies that are trading through some difficult periods, and that can last, one, two, three years. In many cases—clearly not in the case of Carillion—it is dangerous to overreact to short-term difficulties and short-term noise. Where we do get concerned are first, where there is a material change in either management strategy, when for a long period they have said they were going to do one thing and then they change and do another. Secondly, when there is a material and permanent deterioration in cash flows. The



HOUSE OF COMMONS

cash flow is probably the biggest thing, because if the cash flows are there balance sheet issues can be sorted. You can refinance.

Q1124 **Heidi Allen:** Yes, but aggressive accounting can hide that—

Murdo Murchison: Aggressive accounting can hide that.

Heidi Allen: —and did hide that.

Murdo Murchison: Those are the things we would look for. The core questions are management, balance sheet and cash flow. Oftentimes it makes sense to be patient and work through those difficulties. Companies do trade through difficult times and that is a natural part of investing.

Q1125 **Heidi Allen:** So there was nothing, there were no alarm bells that you think you missed. This is not to be negative professionally about your organisation but just the sneaky ways that organisations can hide things from investors, I suppose. Is there anything that you would look at differently now?

Murdo Murchison: I put on record again my frustration with the fact that: yes, we knew there were issues with the balance sheet. Yes, we knew there were issues with short-term cash flow but they were placed in the context of a longer term history of quite attractive margins and apparently secure cash generative contracts and a relatively small construction book. It was less than 20% of profit for that going back over two or three years.

What was brought to the table in July last year was evidence of misstatement of profits over a prolonged period of time, evidence of aggressive accounting and evidence of extremely poor operational management, which was completely at odds with the way the business was presented to the marketplace. Periodically that happens and that is why we run diversified portfolios. You cannot put all your eggs in one or two baskets.

Q1126 **Heidi Allen:** It is probably a little bit different from your point of view, Amra, isn't it, given your index tracking?

Amra Balic: Absolutely, and because of the size of our index book late last year we have announced that we are doubling the global team, so we are going to be just over 60 people globally. I think we are 31 today. I think that stewardship is absolutely critical for us and, to answer your question, are we going to be doing anything different? We do not feel at this point that there is a need to change our process. We do, however, review our guidelines every year just to see if there any things that we need to be more clear about and so on. However, this is really critical, this inquiry, and the findings of your review we will be looking at very closely just to see if there is anything that we can do differently.

For us it is strategy—execution of strategy—that is probably the most critical when it comes to management and the board, and then also how they think about some of the long-term issues because, as an index



investor, we are long-term. We are invested in companies for as long as there is any index and that could be decades. From our perspective, it is thinking about how they are thinking about their human capital. How they are thinking about, let's say, climate change, executive pay, but strategy execution and how they are making adjustment to that strategy through challenging times is our key, if you want, warning signals and what we are focusing on in determining who and when we talk to companies.

Q1127 Chair: A couple of things from me. This is the seventh evidence session we have had now into Carillion and what happened and I think this is the first session where anybody has suggested that there was anything wrong in the business before March 2017. That has been quite refreshing, certainly for me and I expect for other members of the Committee. A number of you said—particularly Amra Balic, but I think all of you—you have relied on publicly available information when you make your investment decisions. Obviously, when you get that publicly available information, you then dissect it and look at it.

I have always been a more avid reader of fiction than nonfiction, but I wonder whether the KPMG audited accounts should be moved in the library from the nonfiction to the fiction section. It seems that you dissected those and other available information from the board.

Amra, you mentioned that you have looked at the board minutes that we have published as part of this inquiry. There were things in those that you do not think gave a true representation of what was happening in the business and so—and other members have asked you about how you might, in the future, look at companies based on what you have discovered about Carillion now—I am interested in how you will look at KPMG audited accounts in the future. Whether you might look at those perhaps a little bit more sceptically as perhaps works of fiction rather than the work that they should be doing, which is giving not just you but ordinary investors.

All of you are able to put a lot of resource into analysing what happened at Carillion and other businesses. How would you look at KPMG audited accounts, or indeed other audited accounts, after you have discovered what you have through the course of this inquiry and the collapse of Carillion? Maybe start with you, Amra Balic.

Amra Balic: I think it is probably a question more for my acting managers rather than me. I would certainly say that my colleagues on active side have a very thorough process and you can argue that is why they did not hold Carillion stock for as long as I have been with BlackRock, which is now seven years. I think that is probably a side I cannot—

Q1128 Chair: Murdo Murchison, do you want to add anything?

Murdo Murchison: Yes. We have looked at our portfolio. We have two other UK listed companies that have KPMG as their auditor. I have two



HOUSE OF COMMONS

draft letters on my desk to write to the chairman of the audit committees at both companies asking for confidence from them that they are comfortable with the quality of the service that they are receiving. I remain puzzled by the fact that someone can be six weeks in a job and discover material issues with contracts, which have been approved by accountants who we are now told are sloppy or whatever other adjectives one cares to use. These appear internally to have been issues that were hidden in plain sight but were not evident to the auditors. That is a puzzle that is yet to be solved.

Q1129 **Chair:** It is a puzzle. Mr Stirling.

Euan Stirling: Yes, if I could continue your analogy. Sometimes reading a set of accounts is like reading a mystery novel, every so often another clue pops out and it helps to inform your opinion of what the company is doing and how its future is likely to be determined. I do share the concern over the audit industry or profession that was expressed earlier. There is a lack of competition. It is a very difficult position for companies when they now have to go through a mandatory rotation exercising. Finding the appropriate choice is a difficult thing to do and there have been some structural suggestions made as to how that might be resolved but that probably goes beyond this committee's remit.

Q1130 **Chair:** We will certainly channel our inner Agatha Christie to try to solve the mystery of what happened at Carillion. Just very finally, you are investors in businesses. On 13 January Carillion wrote to the Government and asked them to essentially be the investor of last resort because they had run out of other options. Do you think that the Government were right to not provide that bailout to Carillion that they asked for and instead to go into liquidation? Do you think the Government had any other options? Maybe start this time with you, Mr Stirling.

Euan Stirling: It is almost impossible to tell. It is from our distance as investors. We do not see the management accounts. We do not have full sight of the progress of the contracts, so I am afraid I am unable to answer that.

Murdo Murchison: I thought our consultant report was very interesting, a review of just the scale of the problem at one point. What was intriguing, in particular, was that management clearly required all of the banks to write off pretty much all of their debt and start afresh. There was a huge complex restructuring here. Looking at it, I am not convinced—even if the Government got involved for the space of providing short-term financing for a matter of weeks—that that was nothing other than a band aid. The structural issues were there. The liabilities relative to the cash flows were just so out of kilter, it is an extreme event. It would be quite reasonable in these circumstances to pass by on the other side. It was not a solution.



Amra Balic: I find it very difficult to answer that question. The Government have considered different options and came to the conclusion that they came to, so I cannot say more than that I am afraid.

Chair: Thank you. We will be talking to Government Ministers as part of this inquiry, but thank you very much to all of you for the evidence today. It has been very interesting.

Examination of witnesses

Witnesses: Andrew Wollaston, Alan Bloom and Lee Watson.

Q1131 **Chair:** Thank you very much for coming to give evidence to our Select Committee this morning. I am not sure if you heard the earlier session but we want to talk to you about your involvement with Carillion when you were called in to do this piece of work for them, right up until the business collapsed in January. We are going to start with Heidi Allen, if that is the case.

Heidi Allen: Thank you very much for coming today. We are finding it quite difficult to piece together the jigsaw of what happened and we have seen many different people giving us evidence so far: Pensions Regulator, investors, internal/external auditors, directors themselves. An awful lot of people say "lessons must be learned". Indeed, I think in your letter to us you said "lessons should be learned". What are those lessons because we are struggling a little bit to know how to stop something like this happening again? Shall we start perhaps with Alan and then move down.

Alan Bloom: Yes, thank you and good morning. Alan Bloom, one of the restructuring team at Ernst & Young. I think there are a number of lessons that we can learn from the way this ended, so the insolvency and the restructuring regime in this country and the way that it may or may not be able to accommodate failures like Carillion's.

I want to touch on that a little bit. I also want to touch a little bit on the sort of thing that has been happening in the financial services sector, where banks and now insurance companies have been asked to provide what were originally called "living wills" but subsequently called "resolution plans", in what are systemically important companies and maybe there is something here about concentration when there is a heavy degree of concentration. Obviously here we are dealing with a non-regulated industry. It is a strange place to start; to start at the end but I think the insolvency and the restructuring profession is, without a doubt, looking at the Carillion situation and, indeed, looked at the Monarch situation and says, "Why is it that in the year 2018 companies as big as this go virtually straight, in Carillion's case, into liquidation and in Monarch's case virtually straight into liquidation?"

Why is it, for example, in the US airlines seem to file for Chapter 11 on an almost monthly basis? Not the same airline but different airlines. Why



HOUSE OF COMMONS

is it that Air Berlin continues to fly when it is insolvent? Why on earth do we end up with a situation where Carillion files for liquidation?

I think while not everything about Chapter 11 is good—and we can talk a little bit about what is not so good about it—what it provided, which Carillion frankly could have done with, was a stay on creditors' actions. A sort of protected, a legal protective bubble, to be put around it so that when it was faced with this difficult situation, extremely difficult situation, it was protected from creditors forcing it into liquidation while it tried to put its plan together. I am sure over the next period of time—

Q1132 Heidi Allen: Is that not just another Elastoplast though right at the end?

Alan Bloom: No, it is not. It would not be done right at the end. I think a reasonable question would be, given that Carillion filed on 15 January: when might the board, if it had been in America or if we had a Chapter 11 type process here, how early on in that process might those directors have filed for a protection? My suspicion is probably around about September 2017. The money that came in, the new debt that was raised, the £140 million of debt that was raised in September 2017, might have provided that capital, the short-term capital that in Chapter 11 would be called debtor in possession finance.

Q1133 Heidi Allen: This is not an area of expertise of mine at all but I do know a little bit about running businesses. It seems to us, the evidence we have heard, this was a fundamentally unsustainable business. It just did not operate in a way with any kind of protection. It was all about dividends and tight margins and never-never-never, always jam tomorrow. Would that not just have exacerbated the problem?

Alan Bloom: No, it would be the opposite. In this country people might say that the equivalent of Chapter 11 is administration but administration is not that at all. Administration is very much an insolvency process. All customers, all suppliers, effectively, have the right to terminate their contracts with a company once it files administration, so effectively it is a juggling act in administration to keep a company trading during administration. In Chapter 11 it is completely the reverse. Nobody is allowed to terminate their contract just because a company has filed for Chapter 11, so it creates a more positive environment to conduct the rescue.

There are some things that are not so great about Chapter 11 I have to say, and in fact successive Governments have looked at this. I know that BEIS itself looked at this probably about three years ago, four years ago, and looked at it again about eight or 10 years ago. It is something that is actively being considered.

Q1134 Heidi Allen: That is the first thing that you say.

Alan Bloom: That is the first one. The second—

Q1135 Heidi Allen: We are just a little conscious of time. Sorry, forgive me; the



HOUSE OF COMMONS

Chair has just given me a nudge on time. If I could encourage you to be a little succinct in your answer.

Alan Bloom: I apologise. Following the global financial crisis and the concern about the failure of systemically important financial institutions, banks were asked to create something that was, at the time, nicknamed a “living will” but subsequently called as a “resolution plan”. In the event that they found themselves in financial crisis in order to make sure that critical services continued to be supplied they were asked to anticipate what would happen in that event.

That is a heavily regulated industry but in companies, such as Carillion, where there is such a concentration of critically important services perhaps something could be done about looking at planning ahead of time; what might be done in the event of financial failure.

Q1136 **Alex Burghart:** Just quickly for me to ask. In the previous session Frank asked Mr Murchison whether he thought that companies like Carillion should be broken up. Mr Murchison very tactfully said he would like to see more competition in this area. Do you agree?

Andrew Wollaston: Auditors, not Carillion. We are all restructuring professionals in front of you today and we compete in our market with a very wide variety of people who do restructuring work. We compete with very large consulting houses. We compete with some of the investment banks. There are a lot of boutiques in our market, many of them have originated from the United States, and then there are lot of accounting firms. Certainly with regard to restructuring work there is a lot of competition certainly in our market.

Q1137 **Stephen Kerr:** If I may ask Lee Watson, you have an interesting dual role here in the Carillion story. You first go in the restructuring capacity with EY and then you are seconded in your own capacity. Is that correct? Just describe that to us.

Lee Watson: That is correct, yes. I, too, am a restructuring partner from EY. I started the engagement as part of Andrew’s team, assisting and advising around liquidity. Then at the beginning of September I stepped out of that role and I joined the group executive on a secondment basis, reporting in to Keith Cochrane, to provide some additional bandwidth in situational expertise around interactions with the financial creditors and assisting with the restructuring.

Q1138 **Stephen Kerr:** When we had the board—we had Phil Green and we had Richard Howson speak to us in an earlier session—they described the culture of the Carillion board and Carillion’s business as honesty, openness, transparency and challenging management robustly in a supportive way. That was what Phil Green said. Richard Howson talked about the culture of openness, mutual dependency, collaboration, strong behavioural values. What did you discover about the culture of Carillion and the culture of the Carillion board?



HOUSE OF COMMONS

Lee Watson: I can talk to my own observations from September onwards where I attended board meetings, and what I would say is that in that time certainly the board was meeting regularly. It was taking advice, not only from EY but from others. It also, in terms of engaging seriously with the restructuring at hand, had formed a restructuring committee, which was meeting regularly. From my perspective, what I saw the board doing in its activities was engaged and appropriate.

Q1139 **Stephen Kerr:** You wrote the report, which you presented to the board on 27 August with Keith Cochrane, where you described a culture of defensiveness and aversion to change at all levels and variable speed and attitudes in response to challenge, so there is a complete divergence here in what you just said and what you wrote in the report.

Lee Watson: Andrew will come in and provide some context. That was a report that obviously he oversaw. What I can tell you is what I observed in the room at that time. The reporting that was going to the board and the papers and the advice that the board was asking for and receiving was fulsome, and I think you may have seen some of the reports. Some of them were produced by EY and some were produced by other advisers.

Q1140 **Stephen Kerr:** Yes, I just quoted from one.

Lee Watson: At that moment in time I would say that it was an open and challenging culture.

Q1141 **Stephen Kerr:** It is described in your own paper as, “Wilful blindness, lack of financial—” I am just reading from the paper.

Andrew Wollaston: Can I clarify?

Stephen Kerr: Yes, please.

Andrew Wollaston: I saw that board minute because it went on your site and I read it. There is a gentleman who made those comments called Stephen Watson, who was a member of the executive committee and was acting as number two to Keith Cochrane.

Q1142 **Stephen Kerr:** Not Lee Watson.

Andrew Wollaston: Not Lee Watson.

Lee Watson: Absolutely apologies. I was not—

Q1143 **Stephen Kerr:** All right, I beg your pardon. I was falsely going after Lee Watson when it was a—

Lee Watson: No relation either.

Q1144 **Stephen Kerr:** No relation either.

Andrew Wollaston: In addition to the board minute that was on your site there was an extract from a report that we wrote, which did make some of those comments. The context of that report is that when we started in July one of the things that we were asked to look at was: could



cost be taken out of the business? What were the cost reduction opportunities? That single page was an extract from a 150-page report, which ultimately identified something like £125 million worth of costs that could be taken out of the business. We made certain observations on that page and some of those observations were made through the data that we looked at.

We were looking at very operational data, and some of it was made through interviews we had with the company's management and we also ran a survey to extract certain information. We did make comments around culture and in particular two places. One was very specific, to the use of the procurement facility, which, if you centralise procurement you take out cost, but if the organisation does not use procurement then you do not take out the cost. There was evidence of a culture of non-compliance with regard to the use of the procure facility.

Q1145 Stephen Kerr: Was that a cultural issue, though? Was that typical or was that an isolated incident?

Andrew Wollaston: We were going for evidential base here. Were there other instances where there was a culture of non-compliance? There might have been but this one was grounded in specific evidence.

Stephen Kerr: I appreciate that. Thank you and apologies again to Lee Watson for misattributing.

Q1146 Chris Stephens: Let us cut to the chase then. What is your assessment of Carillion's management capability?

Andrew Wollaston: We arrived in July and there had been a very large profit warning. I think that is pretty well established. You have to remember that these types of businesses in the construction and services sector, they make most of their money when the economic climate is good and, when the economic climate turns and recession bites—as it did in 2008-09—these companies really have to aggressively manage their cost base.

The first piece of work that we did, which identified all these issues that are on this piece of paper that we talk about and £125 million worth of cost opportunities, seemed to indicate to us that more could be done or have been done earlier to address some of these issues. When we share this report with the board I think they recognised most of the items in them.

Again, we were not there earlier than July, so I cannot comment on how management conducted the business before July from an observational perspective. I can only look at the data and what the data showed us. The cost opportunity across that magnitude across the various areas that are laid out on this piece of paper in the report, seem to suggest to us that there was a lot to do and, arguably, the business had not managed its cost base as aggressively as it might have done over a period of time



HOUSE OF COMMONS

before, but I cannot tell you how many years before, if that makes some sense.

Q1147 **Chris Stephens:** In your reports there are constant references to the quality of people looking at the contracts and the quality and skillset of those at management level, so can I ask you then: was executive pay justified by the performance of the company?

Andrew Wollaston: I had not looked at what the executive managers got paid. I have not compared it with any benchmarks. It is not what we were asked to do, so I am not in a position to answer that question.

Q1148 **Chris Stephens:** You did look at the executive structure and the incentive schemes. You did look at that, is that the case?

Andrew Wollaston: No, we did not. No.

Chris Stephens: You did not look at that. Okay.

Q1149 **Antoinette Sandbach:** Mr Wollaston, you have just said that there was £125 million worth of cost savings and that the business had not managed its cost base. Do you think that should have been picked up by the internal auditors?

Andrew Wollaston: I don't think the internal auditors would have been looking to size the cost reduction opportunity. I don't think that is—

Q1150 **Antoinette Sandbach:** You spoke about the management. That the business had not managed its cost base. Should the internal auditors have picked up that failure to manage the cost base?

Andrew Wollaston: I don't know the answer to that because I don't—

Q1151 **Antoinette Sandbach:** Why not? Why don't you know the answer to that? Is that not something in internal auditor should do?

Andrew Wollaston: Maybe it would be helpful if I explained the whole role. We are restructuring professionals—

Q1152 **Antoinette Sandbach:** No, I understand that your role is different.

Andrew Wollaston: Yes.

Q1153 **Antoinette Sandbach:** Ernst & Young have a broad experience of accountancy and, presumably, audit work, so what I am asking you is: is that the sort of thing that an internal auditor should have picked up?

Andrew Wollaston: I do not review internal audit procedures and papers. I am not an internal audit specialist.

Q1154 **Antoinette Sandbach:** Let me put it another way. You said that in your work you had continued challenges in the quality, accessibility and integrity of data, particularly profitability at contract level. Can you explain what you meant by that?



HOUSE OF COMMONS

Andrew Wollaston: Yes. This company had come together from a series of acquisitions, each with their own data centres, and in our view and in our experience companies that mature post that acquisition build integrate their data systems, often centralised data systems, in order to produce quality information that management can then rely on. In our view, Carillion had not invested sufficiently in data and data analytics and, therefore, in our view, there were areas where that should have been improved.

Q1155 **Antoinette Sandbach:** In a nutshell, that data wasn't there. That integration had not taken place.

Andrew Wollaston: Not to the extent that we would have expected it to.

Q1156 **Antoinette Sandbach:** Again, is that something that an internal auditor, or anyone else coming in and doing your job looking at weaknesses or the ability to get information in the company, should have identified?

Andrew Wollaston: They may well have looked at those things. I don't know what they looked at and what they did not look at, so I don't know whether they identified them or not.

Q1157 **Antoinette Sandbach:** But that was your experience going into the company in 2017 trying to work out where costs were excessive, where there were restructuring opportunities and where there was an ability of management to make gains in terms of cost savings?

Andrew Wollaston: Correct.

Q1158 **Antoinette Sandbach:** Given that you have identified those weaknesses, do you think that those weaknesses would have compromised the ability of any other accountancy firm looking at Carillion to be able to adequately scrutinise the figures in the financial statements?

Andrew Wollaston: Again, I have a difficulty with that question because I don't know what other accountancy firms doing the external audit looked at in terms of audit evidence.

Q1159 **Antoinette Sandbach:** Well, what would Ernst & Young's practice be, Mr Wollaston? If you found those kinds of weaknesses in a company, would it be something that you would highlight to the board and reiterate year after year until they had been remedied?

Andrew Wollaston: I am sorry if I am now answering your question but—

Q1160 **Antoinette Sandbach:** Well, you are not answering my question. I don't know whether either of the witnesses sitting either side of you are prepared to answer the question.

Andrew Wollaston: The difficulty I have—

Q1161 **Antoinette Sandbach:** Sorry, I am asking the other witnesses.



HOUSE OF COMMONS

Alan Bloom: I don't think that I have anything to add. Our role within Carillion started in July and was very much a forward looking role, not really looking back on the relationships that the company had with its external advisers.

Q1162 **Heidi Allen:** Surely, you need to understand what has gone wrong and what has been lacking. I think that is Antoinette's point.

Alan Bloom: What we did, in terms of helping the company to build a business plan going forward, was to effectively construct a business plan from the ground floor upwards, rather than just to inherit what was already being worked on in terms of the existing cash flow, profit and loss and balance sheet.

Q1163 **Heidi Allen:** Gosh, we are still going to learn lessons, aren't we then, if we don't look at the past and what went wrong?

Alan Bloom: It is not in terms of a lesson but it is the practicality of what we had to do, which was to help the company—which is unusual—help them to build a ground up business plan that would be credible to financial stakeholders, creditors, the Government pensions—

Heidi Allen: Sorry, I did not mean to interrupt but I just share Antoinette's frustration.

Q1164 **Antoinette Sandbach:** I want to ask: Deloitte gave us evidence that there was a good proportion where the peer review team, looking at contracts at Carillion, had reached a different conclusion, a more pessimistic view than the position that was taken in what was called the contract appraisal. Is that a view that you concurred with when looking at Carillion?

Andrew Wollaston: We did not look at that. Again, we were looking forward to try to find a solution to the problems. We were not looking back over internal or external auditors' work. It was not within our scope.

Q1165 **Heidi Allen:** I am not sure whether my next couple of questions are going to work on that basis, to be honest, because I was interested to know what your views were on Carillion's general business model, how it had been operating in the past around tight margins, level of debt, around constant acquisitions, around the way it paid its suppliers late, that it became a form of availability of debt. Do you have an opinion on any of those things?

Andrew Wollaston: We have an opinion on that, yes. Clearly there were very tight margins in this business. As our own work showed, there were a lot of costs that had built up that could have been taken out. Those two factors led to losses. Those losses were funded by an increase in debt and obviously pressure on cash flow.

When we arrived in July those were observations that we made. Our work was to come up with a restructuring plan, an operational plan, which largely this is an extract of, which we started to implement with the



HOUSE OF COMMONS

company in September, and also to identify cash improvement opportunities.

Q1166 **Heidi Allen:** Talk to us—unless the Chair thinks I am wrong—less about what you attempted to fix. We are interested more in your views on how the business was being run, if you can give us that view, and whether it was sustainable or not.

Andrew Wollaston: Again, I am going to end up frustrating you all. We arrived in July and our job is to look forward. It is not to look back or to try to form a view on what happened in the past. We are there to try to find a solution that—

Q1167 **Heidi Allen:** How on earth can you convince management to change their behaviours unless you can demonstrate, “The reason you are in this mess is because you did X, Y, Z”?

Andrew Wollaston: Well, our job is not necessarily to convince anyone. Our job is to do the work that we were asked to do, which was very clearly in four clear buckets.

Q1168 **Heidi Allen:** How much did you earn out of this piece of work?

Andrew Wollaston: We charged £13.1 million and we were paid £10.8 million.

Alan Bloom: Through the Chair, with permission, it might be worth explaining why it was necessary to do this grand up business plan. It clearly was necessary. We had recommended it back in August, and bear in mind we only got involved in July. We were uncomfortable with the level of financial forecasting and business planning, so we said to the company, “You need a fully integrated cash flow forecast, profit and loss account, balance sheet, and an explanation of your business plan going forward. Without that you will not get the financial support that you need”.

Q1169 **Heidi Allen:** That takes us back to Antoinette’s question then, surely. Isn’t that the kind of thing that you would have expected the internal auditors to have been demanding from them in the past?

Alan Bloom: I think the reason that Mr Wollaston is answering in the way that he is, is because we were not sitting in judgment on people as to why it was necessary. We—

Q1170 **Chair:** Sorry to interrupt, because maybe we are now getting to the issue. When you go into a business to help restructuring, even the community centre in my constituency would have something to monitor what cash is coming in: what needs to be paid, what is coming in and what is going out. They probably would not get through the month if they did not have that.

You are saying a FTSE 100 company, with an internal audit function provided by Deloitte, an external audit function provided by KPMG and a



HOUSE OF COMMONS

finance director, all of these people in the organisation did not have some of those basics. Is that surprising when you go into a business, Mr Bloom?

Alan Bloom: It is not surprising to us and the reason it is not surprising to us is because, in the work that we do, we are almost always getting involved with companies that are in some sort of financial stress or distress.

Q1171 **Chair:** In the pub in the evening don't you say, "What were these guys doing before we got here?"

Alan Bloom: We don't talk about the cases in the pub in the evening, obviously.

Q1172 **Chair:** In the taxi home.

Alan Bloom: Let's assume hypothetically we were, obviously there are degrees but very rarely do we get involved in a company where the quality of the information is excellent, where the business planning and the forecasting is excellent, because they would probably not be in the difficulty that they were if everything was excellent. What we don't do—

Q1173 **Chair:** So not in the pub but in the wash-up meeting afterwards, do you not say to each other, "We have gone in. We have done all this work. I don't know what these guys in internal audit or the CFO was doing but what a mess it was".

Alan Bloom: Honestly, we don't talk about the auditors and the internal auditors. I have no doubt that the Official Receiver, who is the liquidator who has come in, will have a close look at all parties that were concerned with the company.

Q1174 **Heidi Allen:** I think that what we are trying to get at is, are the internal auditors not contributors to this? They did not push the red warning bell either. Nobody did and then suddenly, "Oh gosh, the company is going under". Is that not a role of the internal auditors?

Alan Bloom: It may well be the role of the internal auditors but it is not our role to work out why somebody did not raise the alarm bell. All we are really saying is we came in with a role to do. We did not know precisely what that role would be when we first arrived. We were asked to do some work on cost reduction and on improving the cash flow, but we did not go back and it would not be a part of our role to go back and say, "Well, how have they got to this point?" We get faced with a situation where we are supporting a company, trying to put a case for it to continue.

Q1175 **Chair:** I will put a different question then. You have been into lots of businesses over the years to help restructure. Some you have succeeded with and some you would not have done. How bad a mess was Carillion in compared with other companies you have gone in to try to help restructure? Was this typical or was this an outlier in not having the basic



HOUSE OF COMMONS

information and systems in place?

Alan Bloom: I would say that this is the only case, certainly in the last 10 years, we have been involved with that has ended up in compulsory liquidation, so clearly the circumstances were chronic.

Q1176 **Frank Field:** That was not the question the Chair asked you, was it? Here you are presenting a model of a big ship setting sail with neither map nor compass and then you are flown on board; the more you talk the more incomprehensible the whole thing becomes to me.

Alan Bloom: Without drawing too much on the analogy it was our role, given the circumstances that the company had reached by the middle of July 2017, to see if it could steer a path to a business plan that would be credible, that would attract capital going forward, and would be supportable by the financial stakeholders. In the event, those financial stakeholders chose not to support that business plan but that was very much our role.

Q1177 **Nigel Mills:** I am intrigued to ask whether you thought the ship was sinking rapidly and should you perhaps have advised them on that a bit earlier than you did.

Alan Bloom: When you get involved in situations like this—and again it is not untypical within the sort of environment we work, and clearly this is a very small percentage of corporate UK but it is a very high percentage of what we get involved with—you find and Carillion, and indeed Mr Watson referred to it, applied on a regular basis a test that is known as the reasonable prospects test. It tends to be applied by the lawyers to the board: is it reasonable for us to continue in business and not to call time by way of liquidation or administration, given the circumstances in which we find ourselves? That test was being continuously applied.

Q1178 **Nigel Mills:** From?

Alan Bloom: From probably August/September.

Lee Watson: It was September.

Q1179 **Nigel Mills:** I have looked at that before. I always have a fear with it that directors convince themselves, “We might win the lottery tomorrow, so it will all be fine. Some magic money might turn up and it will all be okay”. Do you think that test needs to be refined a little so that these sorts of things do not end up in quite the size of mess that they did?

Alan Bloom: I don’t think that any of us believed that liquidation was inevitable until the evening of 14 January.

Q1180 **Nigel Mills:** Okay. Speaking of, “We might win the lottery and be able to pay all our bills”, when you produced some of your work you had some quite optimistic assumptions on what could be disposed of and timings and how much cash could be realised, didn’t you? Were those realistic?



HOUSE OF COMMONS

Lee Watson: Let me take that one because we were there. I think the context for your question, which is important, is it was a very difficult situation and in my experience, from a restructuring standpoint, any company that you get involved in that has an imminent liquidity need is at the more stressed end of the spectrum. Forming a view that you can find and work your way constructively through that is tested. You cannot just decide it. You have to have evidence for it.

The evidence in this case was that the discussions that were entered into with creditors in September were evidencing support in the form of new money and bridge finance, that there was a very proactive and an agreed process set out to allow time in order for—as Messrs Wollaston and Bloom have explained—the business planning process to be carried out to bridge into a restructuring in the first quarter of 2018. That was assessed day by day, and it was grounded on evidence of that dialogue and seeing progress towards that objective.

Q1181 **Nigel Mills:** You produced a report or EY produced a report—one of you did—which suggested that an enhanced breakup of the business would be vastly preferable to what happened in the end, kind of like a forced insolvency. Did you really push management to say, “Look, the best option here is a pretty rapid break up of this” or did you go along with this plan of, “It will all be fine, something will turn up”.

Alan Bloom: If you do not mind—through the Chair—I will take that one. In parallel with producing the business plan for the long-term support of the company, which would have required a £360 million facility to cover that five-year business plan, there was a cash flow forecast to support that, a profit and loss account and a balance sheet to support that. That was presented on 9 and 10 January 2018 to the Government and to the various other financial stakeholders, banks, pensions. But in parallel with the work to build that up over the period October to December—and typical again in these circumstances—banks and other stakeholders said, “What if we don’t support this rescue, what would happen, what are the alternatives? Could you, EY, please model for us what you think will happen if we don’t support this”.

They asked us to model two options. The first one was a straight liquidation immediately, which would have yielded, according to the numbers that we produced, just under a penny in the pound for unsecured creditors. They then asked us to model—with the risks associated with it, which I will come to in a moment—a version of effectively an enhanced liquidation model, which is the one that you are referring to. It still would have been a liquidation but would have provided roughly a two-week window. It would have required £20 million a week from some source or the other to fund it, but it would have provided a couple of weeks to do some distressed sales of property. A fire sale would be a pretty good description of that environment. That would have yielded around about 5 pence to 6 pence in the pound, still a very



HOUSE OF COMMONS

poor return to creditors and certainly not an attractive outcome for anyone.

Q1182 Nigel Mills: When you were doing this work in September/October, what percentage chance did you think the business had of riding this through without some form of very drastic intervention? Was this like a 20% chance or were you very confident that you could keep the ship sailing?

Alan Bloom: We don't put percentages on it but the reasonable prospect test is obviously to some extent judgmental. It is to some extent subjective.

Q1183 Nigel Mills: A 51% chance to get to that?

Alan Bloom: No. The business plan that was produced by the company, which we were very heavily involved in helping to shape, was a very robust plan. It needed £360 million to support it, most of that front-ended to 2018. It was a five-year plan; all of that £360 million would have been needed in the first year and actually £140 million of it in the first four months of the year.

It is a question of creating a business plan that people can believe in and be prepared to lend against, and that was a believable plan. The problem is that we don't get to produce these plans and the company doesn't get to produce its plan in isolation of what is going on. The cash flow needs were such that the company felt it needed to file without ever getting to the point.

Q1184 Nigel Mills: I suppose the problem, Mr Bloom, is some people will believe anything. The reason why I was asking how confident you were is because I think, as a firm, you were quite actively involved in convincing the pension trustees that deferring some pension contributions for I think a return of LIBOR plus 10% on them was a good idea. Obviously it did not turn out to be that great an idea, did it? In hindsight, do you think that was a pretty shocking thing to have negotiated on behalf of the members of that pension scheme?

Lee Watson: Again, if I may take that one because I was a part of those discussions. At the point at which it became clear in early September that new funding was needed, the company approached a range of different creditors for support. The approach to the pension trustees was made in parallel to certain banks and various other creditors. Both of those approaches became quite quickly intermeshed through the course of September, as it became clear—and it is common in these types of situations—that the support of one party is interdependent on the support of another.

I believe the view that was taken by the pension trustees was that agreeing to defer the contributions for a period of time, on terms that were similar to those being asked for by the financial creditors, was the best route towards trying to bridge towards what would have ideally at that stage been viewed as a full rescue of the business.



HOUSE OF COMMONS

What I would say is that at the same time—that was a negotiated settlement, which was done fully advised by them and also with TPR in the room—they were resisting other demands of them in terms of things like granting of security and other things.

Q1185 Nigel Mills: They seem to have been assured that, in the event of insolvency, those payments would have some sort of priority. Is that the case, as far as you know?

Lee Watson: I don't believe they were ever assured of that, no. Given the capital structure of the group, security was not available for any of the lenders apart from £40 million.

Q1186 Nigel Mills: The idea that those deferred contributions would be paid along with insolvency is just wrong?

Lee Watson: It would be a ranking claim and an unsecured claim ranking against all the other financial claims.

Alan Bloom: I think the pensions claims will end up being the biggest claims in the Carillion estate, as a block.

Q1187 Chris Stephens: May I ask a question about the cash flow forecast produced on 27 October? You have factored in clearly in deferring tax payments of £91 million. Was that not wildly optimistic, given that HMRC at that point had not agreed to that deferral?

Lee Watson: If I may, could I just check, when you talk about the forecast you are talking about the short-term cash flow forecast not the business plan?

Chris Stephens: Your cash flow forecast dated 27 October.

Lee Watson: Okay. There were a range of active measures being looked at, day to day, week to week, in order to try to increase the length of the runway to allow the restructuring to take place. That was one of those initiatives that were being investigated. I think it was being done in conjunction with consultants who specialise in that field. As I understand it, it is one of those things where you put a request forward, the request is considered and there is a discussion, a negotiation and certain things out.

Q1188 Chris Stephens: Is it not wildly optimistic, given that at that point HMRC had not agreed to that deferral?

Lee Watson: Certainly they had agreed to a previous deferral in September I believe, albeit at a lower quantum.

Q1189 Chris Stephens: Did you seek to challenge the view that the company could fall back on the state as a last resort, because that is factored in too?

Lee Watson: The business plan that was produced—let's be clear—never assumed that there would be any assistance or compromise from Her



HOUSE OF COMMONS

Majesty's Government. That was never a premise of the plan as it was prepared. As Mr Bloom has referred to, what became clear is the funding requirement that the plan showed, the feedback that we received from creditors was that, in order for that plan to be financeable, it would require certain concessions from Government, alongside their continuance to fund. It was only after that feedback had been received, which was very late in December, that the approach was contemplated.

Chris Stephens: Thank you.

Q1190 **Peter Kyle:** I must admit to being quite frustrated by some of your testimony. The excitement for us or the anticipation for us is that you three very highly trained professionals, with a very broad set of skills, were there inside the company from July, right the way through to the point it collapsed, and yet you seem to be taking an entirely amoral approach to your testimony and refusing to point the finger at anybody for culpability in this. You saw management up close in that period. You saw the auditors, internal and external, and you had access to their documentation, and you refuse to make a judgment as to whether any of them were not acting to the professional standards that we should expect of a company that size.

Alan Bloom: It is not a lack of morality. It is not part of our role to look backwards. In a restructuring, in the sort of environment that we are asked to get involved, a company is stressed or distressed.

Q1191 **Peter Kyle:** You were there at the scene of the crime and you seem to be telling us you were looking the other way when it happened.

Alan Bloom: No. What we were saying is we were absolutely involved from July onwards but we were not looking backwards, and it was not part of our role to judge the directors, the external auditors or the internal auditors.

Q1192 **Peter Kyle:** Among the three of you was there any disagreement? As your project unfolded was there any debate about what you were seeing there, about whether you should be looking at the stability or other areas of the company? Was there any disagreement among your team?

Alan Bloom: I think disagreement would probably be the wrong word, speaking for the three of us. In a situation that is as challenging as this, you obviously debate beyond just the three of us. You debate: what is the right series of actions that we need to take to get the best level of support we can for this company?

Q1193 **Peter Kyle:** I do wonder about the grit and challenge in a team, when I look at the three of you and I see triplets. I don't see much diversity in this team. Is there enough challenge among the three of you? Were you all thinking the same? Were you guilty of group think as you approached this particular project?

Alan Bloom: Clearly, the way in which partners from EY approach these projects there is a certain style that we apply, which is constructive,



HOUSE OF COMMONS

creative. We try to think of ways forward. We try to give the benefit of our experience to our clients in that sense. We expect—

Q1194 **Peter Kyle:** You were paid £10 million. Do you think that was value for money?

Andrew Wollaston: The work that we were asked to do covered broadly—

Q1195 **Heidi Allen:** Can I just ask a question? You keep saying, “Our role wasn’t to do this. Our role wasn’t to do that. The work we were asked to do”. Who does the asking, is it the restructuring industry standard or is it your client? Who is it that so constrained you?

Andrew Wollaston: Our client is the company.

Q1196 **Peter Kyle:** Did the company get £10.6 million worth of value from you?

Andrew Wollaston: We believe so. We identified cost reduction opportunities of £125 million, which we then set about helping the company to achieve. We identified cash optimisation—and cash was important—of about £80 million. We built a series of models. The most important one in my mind was the forecast model, which was built ground up, contract by contract, because when a company needs to negotiate with its creditors it needs to provide a level of information that, arguably, it has never been asked to provide before.

Creditors wanted to see a model where they could literally go to every single cell in the model and properly understand how it had been built up.

Q1197 **Peter Kyle:** You did not save the company. You did not do the thing that could have saved the company.

Andrew Wollaston: Our role is to help the company position itself for a negotiation with creditors. Creditors make their own decision. We could not tell creditors to make the decision to save the company.

Q1198 **Peter Kyle:** Do you think future clients of yours would be advised to pay by results rather than up front?

Andrew Wollaston: We were paid during the course of the assignment. We were not paid in advance.

Q1199 **Peter Kyle:** Listening to your testimony and seeing the outcome of this, do you think future clients would be advised, and well within their duty to their company, to pay you on outcomes after the work is done rather than upfront?

Andrew Wollaston: We were paid on outcomes, so as we completed each piece of our work, as we delivered each outcome.

Chair: A brief question from Antoinette Sandbach.

Q1200 **Antoinette Sandbach:** You said that restructuring involved looking at contracts, going through contract by contract from the ground up. Why



HOUSE OF COMMONS

do you feel that management did not have that information, so that they could themselves judge the weakness of the business and why they had got into the position that they had in July?

Andrew Wollaston: The support we gave to the build up of the contract by contract was to build a model to show to external parties, to see whether or not they would support or to engage their support for the restructuring. That level of detail is typically used in restructuring, not always used by management running their business on a day to day basis.

Q1201 **Antoinette Sandbach:** Do you think that the failure to have the kind of information that you found in a relatively short period—in less than three months you found information that identified £125 million of cost savings—was the management's failure not to have identified that information previously?

Andrew Wollaston: As I said at the beginning, I think £125 million in this business was a lot of money to take out. These businesses need to be aggressively managing their cost base throughout an economic downturn and there was evidence—and it was in our report—that that had not happened with Carillion.

Q1202 **Chair:** Thank you. I have three very short questions that I would like short answers to. You describe going into Carillion and not having some of these basic functions that I would have expected the business to provide or internal audit. Could there be internal audit functions provided by EY, or indeed external audit functions provided by EY, to companies that don't have these basic management information and cash flow forecasts that you described earlier, Alan Bloom?

Alan Bloom: It is obviously open for companies to engage professionals to help them improve their processes and their systems, and that is their choice as to who they select to do this.

Q1203 **Chair:** No, sorry, that wasn't my question. EY, as well as the work you do, provides internal and external audit functions.

Alan Bloom: Yes.

Q1204 **Chair:** Could there be FTSE 100 or FTSE 250 companies, who have internal or external audit functions provided by EY, that don't have some of the basic management information that you have described?

Alan Bloom: I hope not.

Q1205 **Chair:** But it may well be the case. A second quick question: how much did you get paid on 12 January, just a couple of days before the company went into insolvency?

Andrew Wollaston: We were paid £2,090,000 I believe.

Q1206 **Chair:** Are you aware that some companies have been waiting up to 120 days for payment from Carillion, who will probably never get paid? Why



HOUSE OF COMMONS

were you getting your money when subcontractors and small businesses who were owed money by Carillion did not get theirs? Why were you further up the food chain in terms of getting those payments?

Andrew Wollaston: These invoices that were paid in January pre-dated Christmas. It was for work done in October and November. It was billed in December. We were on an agreed payment plan with the company, where the company confirmed to us they were going to pay us on that date.

Q1207 **Chair:** Many small businesses also thought they were on an agreed payment plan but they were never paid and will never get paid. My final question: on 13 January Carillion wrote to the Government—John Manzonei, at the Cabinet Office—asking for a bailout. Did you advise Carillion on that letter that went on 13 January to ask for that money from Government to avoid insolvency?

Alan Bloom: We were certainly one of the advisers that were involved in supporting Carillion at that time.

Q1208 **Chair:** Murdo Murchison, when he gave evidence to our Select Committee this morning, said on this issue of whether the Government should have provided a bailout, for the Government there was a strong argument to walk by on the other side. Do you think Government were right in the end not to bailout this business or do you think they should have done?

Alan Bloom: I think the Government have a lot of factors they need to consider when they get a proposition like this. They were clearly heavily advised by financial advisers as well as lawyers, and they took the decision as others took the decision as to whether to support or not.

Q1209 **Chair:** You advised Carillion to ask the Government or taxpayers for that money; is that right?

Alan Bloom: Not only did we suggest that that was a possible source but they asked all the potential stakeholders as well, and Government as well. Yes, we were certainly supportive of the suggestion that they be asked.

Chair: Okay. Thank you very much the three of you for coming to give evidence to our Select Committee today.